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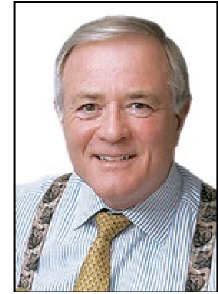
William Rutherford

As economy and markets diverge, will emerging rally continue? | Opinion

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Once the Federal Reserve started on its tight money policy trajectory, the equity markets and the economy diverged. The economy has been generally strong, while the stock market has struggled under the weight of ever-increasing interest rates.

At the close of October, stocks had registered a third straight month of declines, with the Dow down 1.3 percent, the S&P down 2.1 percent and the NASDAQ off 2.8 percent. Two days later, U.S. equity markets treated investors to the biggest weekly gains in a year. Ostensibly, this rally was caused by traders closing out short positions before the weekend due to a trifecta of good news that occurred in the last three business days of that week.

The stock market was boosted first by a pause on rate hikes by the Fed on Wednesday, second by a good enough earnings report from Apple on Thursday (Apple being the dominant stock in the NASDAQ index and in most equity funds), and third by a soft jobs report on Friday. This good news about the economy's resilience, despite lower employment, allowed major indexes to clear significant benchmarks. The Dow Jones had its best week in a year, up 5.1 percent. The S&P and NASDAQ also had their best weeks since November 2022, up 5.85 percent and 6.6 percent, respectively, for the week. The tech-heavy NASDAQ index managed to close above its 50-day moving average – an encouraging development for stock market bulls. The NASDAQ was now up nearly 30 percent for the year. The S&P 500 followed close behind, also bullishly climbing above its 50-day moving average to a gain of 14 percent for 2023 year to date.

The soft jobs report, on top of Chair Jerome Powell's dovish comments on Wednesday, gave traders hope that the Fed might be done with its rate increases. If so, the 10-year Treasury note would stay below 5 percent – an important hurdle that sent fixed-income markets into rally mode. Still, Powell is intent on controlling inflation, which means high rates for longer.

Inflation has a strong, deleterious effect on the economy because it relentlessly pushes up prices, feeding on itself. Higher inflation makes it more difficult for consumers and even governments to pay bills. State and local governments, which unlike the federal government, must balance their budgets, are finding higher interest rates constraining their ability to keep spending at the pandemic levels of zero rates. But since the federal government did not curtail

spending after the pandemic eased and does not even have a budget, let alone a balanced one, the Federal Reserve felt constrained to act to put a lid on inflation.

Higher interest rates place pressure on equity markets, as investors switch to the sometimes-lower risk, certain return of interest-bearing instruments. Still, the equity markets have a certain seasonality to them, with November and December typically posting gains. Market pundits are continuing to speak about the possibility of a "Santa Claus" rally. Positive market sentiment is often self-fulfilling. We think that the equity markets will rally further, in a choppy manner, between now and the end of the year.

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